

January 12, 2004

MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE

FROM Thomas W. Wilson, Jr.
Industry Director, Communications, Technology, and Media

SUBJECT Industry Directive on Stock Options and Cost Sharing Agreements

Final regulations promulgated on August 26, 2003, relating to the treatment of stock-based compensation under qualified cost sharing arrangements, as well as other recent developments, require clarification as to use of resources on the issue of including stock-option compensation in the pool of costs shared under Internal Revenue Code section 482 qualified cost sharing arrangements. This Directive supercedes the January 25, 2002, Industry Directive on Stock Options and Cost Sharing Agreements.

[Treas. Reg. § 1.482-7](#) generally provides that all intangible development costs must be shared among controlled participants in a qualified cost sharing arrangement. Such costs are treated as operating expenses under Treas. Reg. § 1.482-7(d)(1), to be included in the pool of costs to be shared so as to make a controlled participant's share of the costs equal to its share of reasonably anticipated benefits attributable to the development of the intangible under the arrangement. Treas. Reg. § 1.482-7 was amended by [T.D. 9088](#) to clarify that the costs associated with stock-based compensation are among the costs that must be shared and to provide rules for measuring such costs. Treas. Reg. § 1.482-7 is generally effective for taxable years beginning after December 31, 1995. However, the provisions newly added by T.D. 9088 apply to stock-based compensation granted in taxable years beginning after August 25, 2003. The preamble to T.D. 9088 states that no inference is intended with respect to the treatment of stock-based compensation for taxable years beginning before August 26, 2003. Accordingly, the new provisions should not be treated as a departure from existing law. The preamble notes that sharing stock-based compensation in the context of qualified cost sharing arrangements is consistent with the arm's length standard and long-standing policies underlying section 482. The Service continues to maintain its long-standing position that stock-based compensation must be included in the pool of costs to be shared.

For open tax years beginning before January 1, 1996, we will not make adjustments to the cost pool with respect to stock-option compensation. Any pending audits of this issue for these years should be discontinued.

For open tax years beginning after December 31, 1995, we will enforce with respect to stock-option compensation the requirement in § 1.482-7 that all costs attributable to the development of intangibles under a qualified cost sharing arrangement must be shared. Adjustments to effect the sharing of such costs should generally be made as follows:

1. In cases where the taxpayer's return under audit, or position on audit, does not include compensatory stock-option costs in the cost pool, an adjustment should be made. For purposes of this adjustment, take into account only those compensatory stock options granted during the term of the cost sharing arrangement to employees whose services, at date of grant, were related to the intangible development. Disregard employee assignments in or out of the intangible development area after the date of grant. Measure the costs attributable to these compensatory stock options by reference to the difference (spread) between the exercise price and the fair market value of the underlying stock as of the date such options are exercised ("Exercise Date Method"). With respect to statutory stock options (incentive and employee stock purchase plan options):
 - a. For statutory stock options granted in taxable years beginning before August 26, 2003, include amounts in the cost pool only where there was a § 421 disqualifying disposition of the underlying stock by the employee during the taxable year. Measure such amounts by reference to the tax deduction allowable to the taxpayer with respect to the disqualifying disposition.
 - b. For statutory stock options granted in taxable years beginning after August 25, 2003, include amounts in the cost pool whether or not there was a § 421 disqualifying disposition. Measure such amounts by reference to the spread as of the date of exercise. See Treas. Reg. § 1.482-7(d)(2)(iii)(A)(1).

2. Where the taxpayer's return under audit, or position on audit, includes compensatory stock-option costs in the cost pool, adjustments may be made as follows:
 - a. For options granted in taxable years beginning before August 26, 2003, accept the taxpayer's method of determining the amount and timing of costs to be shared if the taxpayer shows that such method is reasonable and is applied reasonably and consistently. If, on the other hand, the method used by the taxpayer is unreasonable or is not reasonably and consistently applied, make an Exercise Date Method adjustment as described in paragraph 1 above. A taxpayer's method of determining the amount and timing of costs to be shared will be found to be reasonable only if the method takes into account all options granted during the term of the cost sharing arrangement to employees whose services, at date of grant, were related to the intangible development.
 - b. For options granted in taxable years beginning after August 25, 2003, the only permitted methods of measurement and timing of costs to be shared are the methods set forth in Treas. Reg. § 1.482-7, as amended by T.D. 9088. Make adjustments accordingly.

I believe this should clarify our approach for the future and allocate resources to those issues that will be sustainable in the post-audit process. This LMSB Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such.